DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS: 02-0510
Indiana Corporate Income Tax
For the Tax Years 1999, 2000, and 2001

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ISSUES

I. **Sale of Inventory Held in Consignment** – Gross Income Tax.

Authority: IC 6-2.1-1-13; IC 6-2.1-2-2; IC 6-2.1-3-3; Reynolds Metals Co. v. Indiana Dept. of State Revenue, 433 N.E.2d 1 (Ind. App. 1982); 45 IAC 1.1-1-3(a).

Taxpayer argues that the income received from the sales of inventory held on consignment within Indiana was not subject to gross income tax.

II. **Abatement of the Ten-Percent Negligence Penalty**.

Authority: IC 6-8.1-10-2.1; IC 6-8.1-10-2.1(d); 45 IAC 15-11-2(b); 45 IAC 15-11-2(c).

Taxpayer maintains that the Department of Revenue (Department) should exercise its discretion and abate the ten-percent negligence penalty assessed at the time of the audit examination.

STATEMENT OF FACTS

Taxpayer is an Illinois based company in the business of manufacturing and selling telephone equipment. Taxpayer maintains an inventory of equipment at two of its Indiana customers' locations. Taxpayer also has an Indiana based employee who deals with its Indiana customers. The Department conducted an audit of taxpayer's federal and state income tax returns. The audit review resulted in a number of adjustments. The taxpayer disagreed with one of the gross income tax adjustments and submitted a protest to that effect. An administrative hearing was conducted during which taxpayer challenged the basis for the gross income tax adjustment. This Letter of Findings results.

DISCUSSION

I. **Sale of Inventory Held in Consignment** – Gross Income Tax.

Taxpayer sells its telephone equipment to various Indiana customers. In order to facilitate sales to two of its major Indiana customers, taxpayer maintains an inventory of equipment at the location of the two Indiana customers. Taxpayer ships its equipment to the customers and retains

ownership of the equipment until the customers have need of that equipment. The inventory arrangement has both a formal, contractual component and is also based upon long-standing extra-contractual understandings with the two major customers.

The taxpayer and the two customers agree in advance on what items should be maintained in inventory. The two customers are able to remove equipment from inventory on an "as-needed" basis. The customers do not need to obtain permission from the taxpayer before removing equipment from inventory. With the first of these customers, taxpayer makes a monthly reconciliation of the equipment held in inventory. Thereafter, taxpayer bills that particular customer for the amount of equipment used. With the second Indiana customer, transfers of equipment are electronically recorded and reconciled. Billing occurs on a continuing basis with the second customer.

Although taxpayer retains ownership of the equipment until removed from inventory, the two Indiana customers bear the risk of loss while the equipment is stored at the taxpayers' warehouses.

By contract, the customers are required to eventually purchase all of the equipment placed into inventory at the customers' locations. In practice and in order to maintain a good customer relationship, equipment which is not eventually acquired and used by the customers, is returned to taxpayer.

The audit determined that taxpayer should have been paying gross income tax on the money earned from the in-state inventory sales. Taxpayer disagrees arguing that these are interstate Illinois-to-Indiana sales, that the sales are conducted in interstate commerce, and the income is exempt from Indiana gross income tax.

Under IC 6-2.1-2-2, Indiana imposes "[a]n income tax, known as the gross income tax . . . upon the receipt of: (1) the entire taxable gross income of a taxpayer who is a resident or a domiciliary of Indiana; and (2) the taxable gross income derived from activities or businesses or any other sources within Indiana by a taxpayer who is not a resident or a domiciliary of Indiana." A taxpayer's gross income includes all gross income not specifically exempted. IC 6-2.1-1-13.

In addition to the specific exemptions allowed within the gross income tax scheme, IC 6-2.1-3-3 codifies the constitutional limits placed upon the individual states by the Interstate Commerce Clause. U.S. Const. art. I, § 8. Specifically, IC 6-2.1-3-3 provides, "Gross income derived from business conducted in commerce between the state of Indiana and either another state or a foreign country is exempt from gross income tax to the extent the state of Indiana is prohibited from taxing the gross income by the Unites States Constitution."

In support of its argument that the income is exempt, taxpayer relies on Reynolds Metals Co. v. Indiana Dept. of State Revenue, 433 N.E.2d 1 (Ind. App. 1982). In that case, the court found that the income Virginia-based Reynolds received from consignment sales was not subject to Indiana gross income tax. Id. at 18. Specifically, taxpayer points to the court's statement that, "The mere maintenance of a security interest in goods located within the state is not sufficient nexus with [Indiana] to justify the imposition of tax upon the secured party . . . ." Id. Taxpayer argues that it

is entitled to the same tax treatment as Reynolds; taxpayer states that, "these sales from the consignment inventory are in form no different than the sales [taxpayer] makes these customers which do not come out of that consignment inventory."

However, the court in Reynolds found that the income was exempt because "[t]he products were shipped, upon order for a stated price, warehoused in consignee's warehouse, (not Reynolds') and insured by the consignee who paid the property tax, and the consignee was given power under the contract and the UCC to defeat Reynolds' title by sale to any person it desired in the normal course of business in its own name, at a price suitable to the consignee." Id. The facts in the Reynolds case are not identical to the taxpayer's own inventory-transactions. In Reynolds, the out-of-state petitioner was transferring the property to Indiana distributors which – in turn – sold the property to Indiana customers. However, taxpayer does not place the telephone equipment at the two Indiana locations in order to allow the two Indiana customers to sell the equipment to third-parties. Taxpayer maintains an inventory of equipment inside Indiana and sells that equipment to the two Indiana customers. The taxpayer does not merely retain a security interest in the property; taxpayer owns the equipment until such time as the Indiana customer decides it needs the equipment. Taxpayer maintains the inventory, the Indiana customers take the equipment out of inventory, and the customers pay for the equipment. Unlike Reynolds, taxpayer is not simply maintaining a transitory security interest in the equipment; taxpayer owns the equipment stored in Indiana until the time arrives that the customers have need of the equipment and remove the equipment from the inventory of available goods.

By placing the equipment on consignment at the Indiana locations, taxpayer has established an Indiana "business situs." 45 IAC 1.1-1-3(a) states that, "A 'business situs' arises where possession and control of a property right have been localized in some business or investment activity away from the owner's domicile." Among other activities, an out-of-state entity may establish an Indiana business situs by "[m]aintenance of an inventory or stocks of goods for sale, distribution, or manufacture." Taxpayer's Indiana business situs is based upon its consignment inventory of telephone equipment over which its exercises possession and control.

Because taxpayer has maintained an inventory of telephone equipment within Indiana, it has established a "business situs." When taxpayer was paid for the equipment in that inventory, taxpayer received "taxable gross income derived from activities . . . within Indiana . . . ." IC 6-2.1-2-2(a)(2).

FINDING

Taxpayer's protest is respectfully denied.

II. Abatement of the Ten-Percent Negligence Penalty.

Taxpayer requests that the Department abate the ten-percent negligence. Taxpayer maintains that it acted in good faith depending on the expertise provided by third-party tax preparers and on the Reynolds decision.

IC 6-8.1-10-2.1 requires that a ten-percent penalty be imposed if the tax deficiency results from the taxpayer's negligence. Departmental regulation 45 IAC 15-11-2(b) defines negligence as "the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." Negligence is to "be determined on a case-by-case basis according to the facts and circumstances of each taxpayer." Id.

IC 6-8.1-10-2.1(d) allows the Department to waive the penalty upon a showing that the failure to pay the deficiency was based on "reasonable cause and not due to willful neglect." Departmental regulation 45 IAC 15-11-2(c) requires that in order to establish "reasonable cause," the taxpayer must demonstrate that it "exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed . . . ."

The Department agrees that taxpayer's failure to report income received from Indiana consignment sales was not the result of a "failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." 45 IAC 15-11-2(b).

FINDING

Taxpayer's protest is sustained.

DK/JM/MR – 032509